

STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6107

Tariff filing of Green Mountain Power Corporation)
requesting a 12.9% rate increase, to take effect)
June 22, 1998)

PREFILED SURREBUTTAL TESTIMONY OF
RICHARD P. SEDANO
ON BEHALF OF THE
VERMONT DEPARTMENT OF PUBLIC SERVICE

November 13, 2000

Summary: Mr. Sedano's testimony explains the rationale behind the decision of the DPS to pursue a settlement with Green Mountain Power in docket 6107. His testimony also explains how the settlement is consistent with this rationale.

Prefiled Testimony
of
Richard P. Sedano

1 Q. Please state your name and business address.

2 A. My name is Richard P. Sedano, 112 State Street, Montpelier, Vermont 05620.

3 Q. What is your present position?

4 A. I am the Commissioner of the Vermont Department of Public Service.

5 Q. What is your educational background and work experience?

6 A. See Exh. DPS-RPS-Sreb-1.

7 Q. What is the purpose of your testimony?

8 A. My testimony explains the rationale behind the decision of the DPS to pursue a
9 settlement with Green Mountain Power in docket 6107. My testimony also explains how the
10 settlement is consistent with this rationale.

11 Q. Please summarize your testimony?

12 A. On behalf of the state, the Department has to decide in this case at this time what to
13 recommend that the Board do about the situation in which GMP finds itself. That situation
14 features the uncertain effect of the imprudence decision in docket 5983, and includes other
15 difficulties facing GMP which compound the complexity of the situation.

16 With the matter of prudence of GMP's management of its participation in the HQ-VJO
17 contract after approval by the PSB in 1990 a given, the question is what to do about the

1 financial implication of this decision. The evidence appears to me to give the Board broad
2 discretion to order a financial result it deems to be in the best interest of the state.

3 In my view, the Board should approve this settlement because it represents a balance of
4 all risks and opportunities presented by this situation, and sets Vermont on a course to fully
5 resolve the matter of the Hydro-Quebec VJO contract for GMP, thus enabling GMP and the
6 state to focus on innovation and service improvements for the benefit of GMP customers. The
7 resources allocated to assigning and valuing responsibility for VJO-HQ contract matters and
8 dealing with risk associated with the lack of resolution of these matters is enormous. It would
9 be a boon to Vermont if these matters could be resolved consistent with the public interest.

10 Among the risks which are addressed by this settlement are GMP's part in the appeal
11 of docket 5983 still before the Vermont Supreme Court and the treatment of any awards which
12 may be made by the arbitration panel in the pending ice storm dispute.

13 I have considered the prospects associated with many possible outcomes of this matter.
14 I conclude that it is in the best interest of the state for the Board to apply conditions such that
15 GMP can permanently resolve the pending issues from docket 5983 in a manner that addresses
16 all financial implications. In this way, the company can proceed, weakened from this
17 experience, but fully capable of providing good service and earning reasonable returns on
18 investments upon implementation of the settlement.

19 Q. What is the rationale behind pursuing a settlement with GMP at this time?

20 A. This answer is complex, but it boils down to an assessment that the best thing for GMP
21 customers now is certainty about the future of the company and its ability to provide quality
22 service at stable rates. The prospect of continued litigation leading to bankruptcy offers results
23 which are too uncertain in value and timeliness. In addition, the overall effect on the electric
24 industry in Vermont of these pending issues is debilitating. Finally, leaving these matters

1 pending for more time is not likely to be financially sustainable – irreversible actions, including
2 bankruptcy, may ensue unless these matters are resolved within the schedule of this docket.

3 Q. What are the elements of the settlement?

4 A. The Third Memorandum of Understanding is attached as Exh. DPS-RPS-Sreb-2. The
5 settlement addresses revenue requirements and allowed return on equity. Raymond Koliander
6 will offer testimony on these topics. Under the terms of the settlement, GMP will receive a
7 3.42% increase over present rates at the conclusion of this docket, and will not seek a rate
8 increase prior to April 15, 2002 except under certain limited conditions. This means that GMP
9 rates will not change again until at least the beginning of 2003.

10 This proposal includes a plan to eliminate seasonal rates in 2001. Mr. Koliander also
11 supports this topic. Our proposal suggests no change to the current treatment of Pine Street
12 obligations, leaving this issue to be resolved in the future.

13 Steven Litkovitz offers testimony on capital spending. Deena Frankel and Mr. Litkovitz
14 propose service quality standards. I am very excited about this part of the proposal. Objective
15 indices measuring GMP's performance will serve to improve service by focusing management
16 attention in an increasingly efficient manner. This work will be useful after GMP's financial
17 condition improves as well.

18 William Steinhurst discusses the range of disallowance options open to the Board and
19 how this proposal relates to these options.

20 I will discuss portions of the proposal that provide for the elimination of certain GMP
21 regulatory asset accounts, the contingency of a significant financial award in the event the VJO
22 are successful in the arbitration with Hydro-Quebec concerning the 1998 ice storm, and a cap
23 on actual return on equity.

24 From GMP's perspective, the settlement would provide for the elimination of risk

1 arising from the prudence of the management of the contract to the present, and a finding that
2 with these provisions, the contract is presently used and useful. Exposure to more significant
3 financial risk of the magnitude discussed by William Steinhurst would be avoided, and GMP
4 would have an immediate opportunity to earn its allowed return on equity. The company would
5 be in a position to recover fully to an investment grade, financially viable firm.

6 Q. Why is it important to GMP customers that these matters are resolved now?

7 A. The electric industry is changing rapidly. Consumers are facing new choices about how
8 they provision their energy services, and on-site solutions are increasingly practical. Utilities
9 have numerous new ways to fulfill their service requirements, both in the field, and in the back
10 office. A utility like GMP must allocate sufficient attention to these new methods to be able
11 ultimately to provide service in the manner that customers will expect, consistent with industry
12 norms.

13 Presently, GMP management is largely focused on survival. Continued diversion from
14 customer-oriented activities can only reduce the effectiveness of the company in achieving
15 consumer expectations.

16 The same can be said for state regulatory resources. The degree to which DPS
17 resources have been consumed by the search for solutions to the financial problems of GMP
18 and other Vermont utilities is enormous. Focusing on future improvements will produce more
19 consumer value.

20 Q. Achieving the original position of the DPS in this case would have lowered rates, is that
21 correct?

22 A. Yes.

1 Q. Wouldn't GMP consumers rather have that result?

2 A. If we could wave a magic wand and eliminate all above market costs associated with
3 Hydro-Quebec from the rates of GMP with no further legal entanglements, then yes, GMP
4 consumers would prefer that result. I have determined that it is unwise to hold out for that
5 result, however, or a result which relies on a significant improvement in the terms of the
6 contractual relationship with Hydro-Quebec.

7 It appears to me that Vermont has a choice between pursuing a course which
8 methodically resolves uncertainties and which positions the company to serve the future needs
9 of its customers, or litigating to the full extent required to assign to the company maximum
10 responsibility for imprudence related to the management of the HQ contract. I am choosing the
11 former, as I will explain in this testimony. To do this, we must resolve outstanding issues, most
12 importantly, the issue of the accountability of GMP in the matter of the management of the
13 Hydro-Quebec contract, and the related findings of the PSB in docket 5983.

14 Q. Before we get into further detail, you have said publicly that the state has a priority of lower
15 electric prices. The Department's direct case in this docket would have produced a large
16 disallowance in costs associated with the HQ contract. Is that correct?

17 A. Yes.

18 Q. The proposed settlement takes a different course. Why?

19 A. I interpreted the PSB order in docket 5983 to be a clear direction to Green Mountain
20 Power to engage with Hydro-Quebec to remake their contractual relationship. I agreed with
21 this objective, since, in my view, the contract was (and is) a barrier to considering constructive
22 restructuring changes in Vermont's electricity market due to forecasted levels of above market
23 costs and its duration.

1 Hydro-Quebec executives seemed to agree with this assessment, and did engage with
2 GMP in an effort to remake the contract. While progress was slow through 1998 and 1999, I
3 was encouraged by the effort on both sides. This progress led us to join in a recommendation
4 that the schedule in this docket be extended to allow for further time to pursue a negotiated
5 agreement.

6 Late in 1999, there was a management change at Hydro-Quebec in its power
7 generation organization. Since that time, there appears to have been a philosophy change at
8 Hydro-Quebec as well. Instead of a focus on external market *customers*, I believe the current
9 focus is on energy markets and maximizing profits for the province-owner. Based on the
10 actions of HQ over the past year, including cancelling or disabling several long-standing power
11 contract relationship, I think the chance of a negotiation between GMP and HQ yielding
12 significant benefits to Vermont is poor.

13 Q. So you are urging the PSB to make the best of the situation, recognizing that HQ will not move
14 on the contract?

15 A. Yes.

16 Q. Since the contract still represents such a large amount of above market costs for consumers,
17 and since the company was imprudent in its management of the contract, why should the PSB
18 accept this result?

19 A. Given the poor prospects for mitigation of the HQ-VJO contract, pushing for the
20 maximum disallowance could cause irreparable harm, and the chances for success in securing
21 consumer benefits as a result of the maximum disallowance are uncertain. We are talking about
22 bankruptcy. It is impossible to see a clear course to the future if the PSB makes a disallowance
23 of HQ contract costs in this case which, in turn, leads to bankruptcy. My conclusion is that

1 success for consumers and anyone else is very uncertain (except for the hired lawyers and
2 experts), and risks to continued quality of service in the meantime and for some time after
3 resolution are very real and difficult to manage. While these quality of service risks can be
4 managed, this requires great effort on the part of the regulator and the consumer advocate, and
5 sustaining this effort successfully will be a difficult challenge. We have already seen some
6 tendency at GMP to let service levels slip without extra regulatory oversight. Such oversight
7 will be hard to sustain and ultimately unreliable if the company is fundamentally concerned about
8 cash preservation over some years.

9 Q. So you have made a judgment balancing chances of success and possible outcomes of the
10 different choices and determined which course best furthers the public interest?

11 A. Yes.

12 Q. And you believe this settlement best balances these interests?

13 A. Yes.

14 Q. Doesn't this proposal concede that Vermont will have the high rates that your original case
15 seemed designed to avoid?

16 A. My concern is that despite the strength of our original case, there are many other
17 possible outcomes than total avoidance of all above market costs. While it is expected that all
18 sides will report confidence of victory, the outcome of a fully litigated scenario is unknowable.
19 The opportunity cost of waiting for this resolution is not factored in the concern expressed in the
20 question. There has already been a significant disallowance of HQ-VJO costs between March
21 1, 1998 and January 23, 2001, and other consideration is provided in the proposal such that
22 consumers will not have to pay further amounts in recognition of the company's imprudence.

1 The burden on GMP over these three years does represent a deterrent against future
2 imprudence, and this point is further brought home by accounting concessions from GMP in the
3 settlement. The sum is sufficient to justify the proposal from the point of view of the consumer.

4 Q. Do you have an opinion on the message this proposal would send to a utility which is thinking
5 about taking a power supply risk? Are you saying that the utility can always rely on the
6 consumer to backstop its risk, at least to this extent, regardless of the performance of the utility?

7 A. This is a very important point. A vertically integrated utility in Vermont will continue to
8 bear the risk of operating its system under the terms of the franchise as delineated by Vermont
9 law and interpreted by the Board. The outcome of this case will not change that foundation of
10 utility regulation in Vermont. The Board should consider maximum risk exposure and ability to
11 manage that risk when considering any significant utility financial commitment for approval. A
12 different regulatory structure, realigning risk would certainly address this concern.

13 Q. So you have made a judgment balancing chances of success and possible outcomes of the
14 different choices and determined which course best furthers the public interest?

15 A. Yes.

16 Q. And you believe this settlement best balances these interests?

17 A. Yes.

18 Q. Please describe the settlement from your point of view.

19 A. First, it is important to reiterate that this settlement represents a decision that
20 going for certainty and resolution is preferred to a course of litigation with a very uncertain
21 outcome. The settlement includes significant concessions both on the part of the company and

1 on the part of the consumer. It also provides for an excellent plan to secure value for customers
2 in the area of service quality.

3 GMP agrees to freeze its rates through calendar year 2002 except under certain
4 conditions. This is very tangible evidence of stability to the consumer. GMP also agrees to
5 remove regulatory assets from its deferred state regulatory expenses account totaling \$3.2
6 million. In addition, GMP agrees to forego any return on unamortized balances from two other
7 regulatory asset accounts, one for the costs of the ice storm arbitration, and another for
8 renegotiation of the HQ contract. In total, this represents a reasonable financial settlement in
9 return for waiving further prudence disallowances regarding the Hydro-Quebec contract, and it
10 will also serve to stabilize rates out into the future as these costs are removed from revenue
11 requirements for years into the future. This result leaves the company with a weak balance
12 sheet, but with sufficient cash flow and a pathway to grow expeditiously back to financial
13 health. This is especially the case since the proposed settlement requires that GMP not
14 increase its dividends until it has obtained new permanent long term financing. Consumers are
15 also protected from the prospect of windfall profits by a cap on the company's actual return on
16 equity during the period of the rate freeze. It is important that GMP's owners have the
17 opportunity to receive a reasonable return on investment. It is also important that in
18 consideration for the significant puts and takes which are involved in this proposal that the
19 company not be allowed to retain excess profits at this time.

20 GMP also agrees to end the legal suspense brought about by its appeal of the PSB
21 order in docket 5983 to the Vermont Supreme Court by withdrawing that appeal. Taken
22 together, these elements represent a reasonable financial settlement of the difficult issue of
23 deciding what to do to resolve the pending questions left from docket 5983.

24 As part of the proposed settlement, the consumer concedes its right to argue that
25 GMP's imprudent actions in managing the Hydro-Quebec contract, as found by the Board in

1 docket 5983, should produce further cost disallowances beyond this docket. In other words,
2 the prudence of the HQ matter in docket 5983 is resolved. I will let others characterize the
3 value of this right, but I believe it is significant, though still very uncertain, given there has been
4 no final Board ruling on disallowances.

5 In addition, GMP gets the revenue it is asking for in docket 6107, and the allowed
6 return on equity it is asking for also. Based on the analysis I have seen, GMP will immediately
7 have a reasonable opportunity to earn its allowed return on equity under the circumstances of
8 this settlement. Further, GMP and DPS agree that eliminating seasonally differentiated rates in
9 2001 is appropriate, and our agreement offers a plan to accomplish that.

10 This settlement is not just about resolving past disputes. It is also about setting a clear
11 course for the future. The settlement addresses expectations for service quality, capital
12 spending, and right-of-way maintenance in ways explained by other witnesses.

13 The settlement also makes clear that any net benefits from the arbitration between the
14 Vermont Joint Owners and Hydro-Quebec concerning the ice storm of 1998 will flow to
15 consumers.

16 Q. Is it fair to say that you are looking for as much certainty for consumers as is possible given the
17 circumstances?

18 A. Yes.

19 Q. The rate freeze is subject to some conditions. Please explain why the rate freeze can't be
20 unconditional.

21 A. GMP is facing a significant set of uncertainties in its power supply obligations. These
22 will be discussed by others. My distillation of this set of circumstances is that the company in
23 the cause of assuring quality service does need to have the opportunity under limited

1 circumstances to come to the Board and request additional revenue. It is important to note that
2 the Board is under no requirement to grant any request by the company unless the Board finds
3 it in the public interest to do so.

4 Q. Are you concerned about the financial health of GMP in the event this settlement is approved?

5 A. I have considered that financial health of GMP under this scenario. I think it is
6 important that this settlement lead to a situation where the company can eventually access long
7 term capital at reasonable rates. I believe relief from the risk of further disallowances related to
8 the docket 5983 findings on the management of the Hydro-Quebec contract, and setting rates
9 to allow a reasonable opportunity to earn the company's allowed rate of return, coupled with a
10 conservative dividend policy by the company, will enable the access to capital which GMP
11 needs. Mr. Ross further addresses access to capital.

12 Q. Should the PSB be concerned about the dividend policy of the company?

13 A. The dividend policy of the company represents choices on how the company will use its
14 earnings to restore its financial health. Since this settlement is designed to accomplish this
15 purpose, the Board should be interested in the expected dividend policy of the company.

16 The financial structure of GMP is weak. The settlement pushes the company quite far,
17 yet provides an opportunity for the company to regain its strength over time.

18 Q. What specific indicators should the Board look at pertaining to the dividend policy?

19 A. Coming out of the settlement, the company will be seeking improved conditions for
20 access to capital. The ultimate objective is investment grade long term debt. I expect that this
21 objective will be achievable after some period of successful earnings performance.

1 Q. What indicators do you look for to show that the course you recommend is likely to be
2 successful from the state's point of view?

3 A. For the company to deliver the service levels I believe it can and should, the company
4 must be financially sound. I believe this settlement puts the company on a footing which will
5 allow it to earn amounts necessary to eventually provide it access to capital, capital necessary
6 to deliver on expectations at a reasonable cost.

7 If the settlement is approved, I expect that some period of good financial performance
8 will be necessary before normal long term borrowing can resume. In the meantime, securing
9 some combination of bank financing similar to the existing credit line and somewhat more
10 desirable bridge financing will be a good indicator of progress.

11 Q. What do you mean by eventually?

12 A. The period of high risk and low earnings which GMP is in right now has hurt the
13 company's ability to instill confidence in the markets from which the company sells debt and
14 equity. I believe removing the high risk, and providing for reasonable earnings will put the
15 company on a track to perform within industry averages for utilities. However, it does not
16 appear to be reasonable to expect the full transition to wellness to happen overnight. The
17 capital structure of the company has been weakened by the events of the past three years. It
18 will take a modest period to restore the company's key ratios to a status equivalent to a clean
19 bill of health. While this will not happen right away, approving this settlement will enable this
20 result within a modest period of time. As I have said, bridge financing will likely be feasible and
21 desirable after the adoption of this settlement, and after a few quarters of reasonable earnings,
22 long term financing will be feasible and desirable.

23 Q. Please discuss the broad policy issues the Board should consider as they consider this

1 settlement.

2 A. I have already discussed the basic consumer issues of reliability and service, and how
3 the settlement is likely to improve and stabilize the quality of these attributes. This is very
4 important.

5 On a broader perspective, the state of Vermont has come to the time where we must
6 decide what we are going to do about the prudence findings in docket 5983 – specifically, the
7 financial implications of those findings on GMP. The regulatory and political institutions in
8 Vermont must consider the effort of the past 30 months in response to the Board's order and
9 determine the most sensible course from here. The state must apply a solution to this situation
10 which demonstrates confidence that our institutions can make tough decisions, and a good
11 decision in these tough circumstances.

12 Naturally, the issue of rate comparisons with other states is important. I have
13 expressed the concern that if trends in other states indicate that Vermont rates are going up
14 while rates in other states are going down, this is a matter of some importance and concern.
15 But this point does not address how to develop policies which will put Vermont rates on a trend
16 toward the lowest levels possible (consistent with maintaining appropriate socialized benefits of
17 the system). Without the benefit of perfect foresight, I judge that this settlement puts Green
18 Mountain Power in a position of looking forward to how the system can improve and serve
19 customers better, and puts the company's regulators in a position to focus on bringing these
20 improvements to reality. With the degree of financial accountability which the company has
21 already experienced, I think it is time to wrap up the concerns of docket 5983 and move on.

22 Q. These thoughts have application to the other utilities involved in the VJO contract, is that
23 correct?

24 A. I believe this is correct. In various ways, all the electric utilities in Vermont are in some

1 state of suspense awaiting a resolution to these matters. There are several utilities with
2 temporary rates. Stakeholders in those systems wonder about the fast-accumulating potential
3 for refunds. Municipalities face some level of risk through the municipal electric departments.
4 VELCO is looking at the need to make some investments in its system and may require access
5 to capital. Vermont institutions responsible for reliability must have clear access to the means
6 necessary to support reliable service. The health of GMP was an issue in the proposed sale of
7 Vermont Yankee and mitigating this concern presented significant additional issues to the Board
8 and the parties beyond just the value of the facility and the value exchanged.

9 I believe this settlement puts Vermont on track to look forward to progress in the
10 electric industry here, and is a fair resolution of the pending issues from docket 5983.

11 Q. Does this conclude your testimony?

12 A. Yes.